

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:NR:HOU:TL-N-4171-0

RTCummings

date: APR 5 2001

to: Bud Schroeder, Team Manager  
Group 1381, Stop 1381-HOU  
Houston District

from: Richard T. Cummings, Attorney (SB/SE)  
IRS Counsel, Houston

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subject: Nondocketed Significant Advice

Case #: TL-N-4171-00

UIL Nos.: 1002.03-00 Exchanges  
1001.14-01 Valuation (bonds)  
1273.02-03 Debt issued for property where there  
is public trading  
1502.93-00 Intercompany transactions

This is to advise you of our conclusion regarding the [REDACTED] debt exchange issue. As you know, we had intended to submit a request for field service advice to the National Office. However, after certain facts were clarified, we agreed that it should be handled as a memorandum of Nondocketed Significant Advice pursuant to CCDM § (35)3(19)4. Under these provisions, the National Office will review our advice and notify us whether it concurs, believes modification is appropriate, or needs additional information.

ISSUE and CONCLUSION

Was [REDACTED] entitled to deduct \$ [REDACTED] on its [REDACTED] income tax return when it refunded certain outstanding promissory notes with new obligations issued by an affiliated corporation?

We have concluded that the deduction was properly reported.

## ASSUMPTIONS

We have not reviewed the underlying legal documents. Our description of the facts is based on information from the examination team and the taxpayer. Both groups reviewed an earlier draft of the Facts section of this memorandum, and this version reflects corrections agreed on by both sides.

We do not express an opinion on the taxpayer's valuation methodology or computations. Similarly, we do not express an opinion on the accuracy of the agent's computations. However, it appears that the agent may have applied an inappropriate valuation method. Although this is not a legal matter, we believe it is appropriate for us to address it.

## FACTS

[REDACTED] was a large public company with interests in [REDACTED] business groups: [REDACTED]; [REDACTED] and [REDACTED]. In [REDACTED]'s management decided to restructure the company. The [REDACTED] and [REDACTED] groups were to be spun off as two separate publicly-held companies. The [REDACTED] group was placed in a new corporation that was given the name "[REDACTED]" and is referred to as "[REDACTED]." After the spinoff of [REDACTED] and [REDACTED], [REDACTED] held only the [REDACTED] group. [REDACTED] was then merged into a unit of [REDACTED]. The spinoffs and merger occurred on the same day.

The restructuring plan necessarily included a complete restructuring of [REDACTED]'s capital structure. The capital restructuring included an exchange of certain [REDACTED] promissory notes having an aggregate adjusted issue price of \$[REDACTED] for [REDACTED] promissory notes valued by the taxpayer at \$[REDACTED]. [REDACTED] deducted the difference, \$[REDACTED], as a redemption premium. The examination team has questioned whether this deduction was proper.

## 1. Terminology

NOPA: a Notice of Proposed Adjustment drafted by Financial Products Agent Larry G. Butler, issued to the taxpayer on or about [REDACTED] and subsequent clarifying memos. (The NOPA and related documents are not attached, as they include extended discussions of issues that have been determined to be irrelevant.)

\_\_\_\_\_: the original issuer of certain promissory notes that were exchanged for newly-issued promissory notes issued by \_\_\_\_\_.

\_\_\_\_\_: the issuer of the promissory notes that were issued in exchange for certain outstanding \_\_\_\_\_ promissory notes.

Debt Instruments ("DIs"): the promissory notes issued by \_\_\_\_\_ or \_\_\_\_\_ that were exchanged for the \_\_\_\_\_ promissory notes.

Exchange Offer: the offer to the holders of \_\_\_\_\_ s DIs to exchange them for \_\_\_\_\_ DIs.

Exchange Offer Period: \_\_\_\_\_ through \_\_\_\_\_.

Exchange: the exchange of \_\_\_\_\_ DIs for certain \_\_\_\_\_ DIs.

Exchange Agent: \_\_\_\_\_ which served as transfer agent to handle the mechanics of the Exchange.

Indenture Trustee: \_\_\_\_\_ which served as trustee under the indentures governing the old and new DIs.

Old Indenture: \_\_\_\_\_ indenture agreement with \_\_\_\_\_ under which \_\_\_\_\_ acted as trustee for the holders of \_\_\_\_\_ s DIs.

New Indenture: \_\_\_\_\_ amended agreement (and later supplements) with \_\_\_\_\_ under which \_\_\_\_\_ was appointed trustee for the debt holders who had accepted the Exchange Offer.

Expiration Time: \_\_\_\_\_ time, on \_\_\_\_\_ (a Tuesday). The Expiration Time marked the end of the Exchange Offer.

Issuance Date: contractually defined as the first New York Stock Exchange trading day after the end of the Exchange Offer Period. The Issuance Date therefore was \_\_\_\_\_ (Wednesday). The \_\_\_\_\_ DIs were issued to the Exchange Agent on the Issuance Date.

Issue Date: the effective date of the Exchange for federal tax purposes; not necessarily the same as the taxpayer-defined Issuance Date.

Exchange Date: contractually defined by the taxpayer as the third NYSE trading day following the Expiration Time, or as soon thereafter as possible. On the Exchange Date, the Exchange Agent delivered (mostly by book-entry) the [REDACTED] DIs to the holders of [REDACTED] DIs who had accepted the Exchange Offer. The NOPA takes the position that the Exchange Date was [REDACTED] or later. The taxpayer claims the Exchange Date was [REDACTED] (the Expiration Date) or [REDACTED] (the Issuance Date.)

## 2. Chronology

[REDACTED]: [REDACTED]'s Board of Directors approved the plan of restructuring, including the Exchange.

[REDACTED]: [REDACTED] was incorporated.

[REDACTED]: The IRS issued PLR 240198-96 to [REDACTED], addressing certain tax aspects of the restructuring.

[REDACTED]: beginning of the Exchange Offer Period.

[REDACTED]: [REDACTED] percent of [REDACTED]'s stockholders voted to approve the restructuring plan.

[REDACTED]: close of the Exchange Offer Period.  
[REDACTED] percent of the holders of [REDACTED] DIs accepted the Exchange Offer.

[REDACTED]: the last day of existence of the [REDACTED] consolidated return group.

[REDACTED]: the Issuance Date. [REDACTED]'s DIs were delivered to the Exchange Agent.

[REDACTED]: [REDACTED]'s DIs were listed on the New York Stock Exchange. Trading did not begin until some time in [REDACTED]. The fair market value of the DIs as of [REDACTED] was established by a study by [REDACTED].

██████████: the spinoff of ██████████ became effective. ██████████ was the first day of ██████████'s existence as an independent company, and the first day of its first fiscal and tax years. ██████████ filed a short period tax return for the period ██████████ through ██████████.

██████████: ██████████ merged with a subsidiary of ██████████ and changed its name to ██████████.

██████████: the date the Exchange Agent was required to transfer ██████████'s DIs to the ██████████ debt holders who had accepted the Exchange Offer. If the Exchange Agent could not make delivery on ██████████, it was required to make delivery as soon thereafter as possible.

██████████ (exact date unknown): trading of ██████████'s DIs on the New York Stock Exchange began.

### 3. Description of the DIs

Following is a comparison of some characteristics of the ██████████ and ██████████ DIs:

- They were issued by different companies.
- ██████████ was substantially smaller than ██████████. ██████████ represented approximately ██████████ percent of ██████████'s total assets, revenues, and income.
- ██████████'s DIs bore an interest rate ██████████ basis points (██████████ percent) higher than the ██████████ DIs they replaced.
- The DIs had the same maturities.
- The issuer's obligations under the Old Indenture and the New Indenture (the Negative Pledge Covenants and Events of Default) were similar in most respects.
- The prospectus describing the Exchange Offer informed ██████████'s debt holders that the Exchange would be a taxable event to them if they accepted the Exchange Offer, but not if they declined.

#### 4. Execution of the plan.

A Prospectus and Consent Solicitation dated [REDACTED] was mailed to the [REDACTED] debt holders. By the Expiration Date, [REDACTED] approximately [REDACTED] percent of the holders had accepted the exchange offer and tendered their securities to the Exchange Agent. On [REDACTED] the [REDACTED] DIs were transferred to the Exchange Agent for delivery to the debt holders and were listed for trading on the New York Stock Exchange. Also on [REDACTED] in a circular non-cash transaction, [REDACTED] "sold" the [REDACTED] DIs it had just acquired to [REDACTED] for the fair market value of the [REDACTED] DIs estimated by [REDACTED]. [REDACTED] immediately declared a dividend in the same amount to [REDACTED]. These transactions were executed on paper; no funds changed hands.

On [REDACTED] [REDACTED] was an independent publicly-owned company. [REDACTED]'s shares were listed on the New York Stock Exchange, and it became the parent of a new consolidated group for tax and financial accounting purposes.

#### 5. Financial accounting treatment

The exchange was treated consistently for book and tax purposes. Under generally accepted accounting principles, long-term debt is recorded at present value. Any difference between the face amount of the debt and its present value at the time of issue is accounted for as either a discount or premium. The discount or premium is amortized over the term of the liability, effectively increasing (discount) or decreasing (premium) interest expense. When a long-term liability is extinguished prior to maturity, the difference between the reacquisition price and the carrying amount is accounted for as an extraordinary gain or loss from extinguishment. This is true whether the debt is reacquired for cash or refunded (reacquired in exchange for new debt.) See Kieso and Weygandt, Intermediate Accounting, 9<sup>th</sup> Ed. (John Wiley & Sons, Inc., 1998), pp. 699-713.

Issue costs are treated as deferred charges amortized over the life of the debt. Accounting Principles Board Opinion No. 21 (1971). When a refunding occurs, unamortized issue costs are included with the carrying value of the debt in the computation of refunding gain or loss.

██████████ reported an extraordinary period loss on the Exchange in the same amount as its tax deduction, \$██████████. ██████████ recorded a premium on bonds payable in the same amount. ██████████ is amortizing the premium over the term of the DIs, thereby reducing periodic interest expense for financial purposes as well as its federal tax interest deduction.

#### 6. Tax treatment

██████████ reported a tax deduction of \$██████████ on the Exchange. ██████████ entered into a tax sharing agreement with ██████████ whereby the tax benefits resulting from the loss were paid to ██████████. However, both companies were in a position to immediately obtain the tax benefit of the deduction through net operating carrybacks to the three preceding years.

██████████ recorded a premium on the issuance of its DIs, in the same amount as ██████████'s deduction. ██████████ is amortizing the premium over the term of the DIs. The premium amortization reduces deductible interest expense because the stated rate of interest includes a return of capital that is not deductible by the issuer nor taxable to the holder. In effect, ██████████ is "recapturing" ██████████'s deduction of the exchange loss over the term of ██████████'s DIs.

The prospectus for the Exchange advised holders that they would be required to recognize gain or loss on the Exchange and to report payments of interest, net of premium amortization, as income. No information on the value of the ██████████ DIs was distributed to the debt holders. In principle, each exchanging holder was required to make his own determination of the value of ██████████'s DIs and report his gain or loss. We have no information on how many of the debt holders actually did report their gain or loss on the Exchange. It is possible that many failed to report it at all.<sup>1</sup>

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<sup>1</sup> Since ██████████ did not communicate ██████████'s estimate of the value of the ██████████ DIs to the debt holders, only by the most improbable of coincidences would their tax treatment of the Exchange be symmetrical with ██████████'s. Any debt holder who failed to report a gain on the Exchange equal to ██████████'s deduction is receiving an undeserved tax benefit from ██████████'s premium amortization. The debt holders' tax treatment of the Exchange has not been examined and is not within the scope of this advice.

## ISSUES and POSITIONS

The deduction can be analyzed from two different, but not mutually exclusive, approaches. The first approach is to analyze whether a sale or exchange occurred under I.R.C. § 1001 and Treas. Reg. § 1.1001-3. The second approach is to analyze whether the consolidated return intercompany transaction rules under Treas. Reg. § 1.1502-13(g) apply.

The sale or exchange analysis requires consideration of whether the Exchange was a taxable event, and if so, how the gain or loss (as in this case) should be characterized.

The Agent's position is that a sale or exchange did not occur. A substantial modification of [REDACTED]'s debt did not occur. The Agent argues that the terms of the DIs were similar, the holders' payment expectations did not change as a result of the Exchange, [REDACTED] acquired substantially all of [REDACTED]'s assets, and [REDACTED] took over [REDACTED]'s management and headquarters offices.

The taxpayer argues that the sale or exchange analysis is irrelevant. The taxpayer's position is that the consolidated return regulations preempt Treas. Reg. §§ 1.1001-1(a) and 1.1001-3, and in any event, the sale or exchange provisions apply to the debt holders, not the issuer. If the sale or exchange analysis were relevant, however, the taxpayer would disagree with the Agent's contention that [REDACTED] acquired substantially all of [REDACTED]'s assets.

The taxpayer relies on Treas. Reg. § 1502.04-13(g), which, it says, explicitly describes the Exchange and specifies its tax consequences. [REDACTED]'s DIs became intercompany obligations when they were acquired by [REDACTED] and were deemed satisfied immediately on acquisition. The premium paid to acquire the old obligations is a separate-company deduction item that belonged to [REDACTED].

The Agent argues that the Exchange occurred on the statutorily-defined Issue Date, not on a date defined by the taxpayer. The Issue Date is defined as the date on which the [REDACTED] DIs were distributed to the exchanging debt holders. The Issue Date occurred after [REDACTED] had been spun off and left the [REDACTED] consolidated return group. But even if the consolidated return regulations applied, the Agent argues, the Exchange does not fall under Treas. Reg. § 1502.04-13(g) because the [REDACTED] DIs were not intercompany obligations.



The Agent also argues that the steps by which [REDACTED] acquired the DIs [REDACTED] had received in exchange for its newly-issued DIs was a circular transaction that lacked economic substance and should be disregarded. If the circular transaction is disregarded, [REDACTED] did not incur a loss on the Exchange because it did not satisfy the old DIs.

Treas. Reg. § 1.1502-80 provides that the Code and other legal principles apply to consolidated return groups to the extent the consolidated return regulations do not exclude them. The intercompany transaction rules provide a parallel rather than an inconsistent method of analyzing the Exchange. They do not expressly or implicitly exclude the application of I.R.C. § 1001 and the regulations thereunder.

This memorandum addresses both the sale or exchange and the consolidated return approaches. We conclude that the deduction was proper under either approach. I.R.C. § 1001 and the regulations thereunder apply to the issuers as well as debt holders, as shown in a recent Field Service Advice. In FSA 199910009 (December 2, 1998), 1999 TNT 49-88, the National Office issued advice on an issuer's deduction of original issue discount resulting from a restructuring of corporate debt. The transaction was analyzed under Reg. § 1.1001-1(a).

In a memorandum dated [REDACTED], the agent proposed an alternative position, under which approximately half of the deduction would be disallowed (\$ [REDACTED] rather than \$ [REDACTED]). The agent's theory for the alternative position is that Treas. Reg. 1.1273-2(c) applies, and directs that the value of the [REDACTED] DIs be equal to the market value of the [REDACTED] DIs prior to the Exchange. We disagree with the agent's interpretation of the regulations. In addition, though not a legal matter, we believe that the agent may have applied an inappropriate valuation method to arrive at the market value of the [REDACTED] DIs.

#### LAW

I.R.C. § 163(a) allows a deduction for interest paid or accrued during the taxable year.

Treas. Reg. § 1.163-7(c) states that if a debt instrument is repurchased by the issuer for a price in excess of its adjusted issue price, the repurchase premium is deductible as interest in the taxable year the repurchase occurred.

Treas. Reg. § 1.163-7(c) further provides that if a debt instrument is repurchased in a debt for debt exchange, the repurchase price is the issue price of the new debt. The exceptions to this rule do not apply to the instant case.

I.R.C. § 1001(a) requires the recognition of gain or loss on the sale or other disposition of property. Treas. Reg. § 1.1001-1(a) requires that gain or loss be recognized "from the exchange of property for other property differing materially either in kind or extent."

Treas. Reg. § 1.1001-3 governs modifications of debt instruments after September 24, 1996. Sec. 1001-3(a)(1) specifically includes exchanges of debt instruments within the scope of the regulations.

Treas. Reg. § 1.1001-3(b) provides that "a significant modification of a debt instrument, within the meaning of this section, results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent. A modification that is not a significant modification is not an exchange for purposes of § 1.1001-1(a).

Treas. Reg. §§ 1.1001-3(c) and (d) define "modification," while §§ (e) and (f) define "substantial."

Treas. Reg. § 1.1001-3(c)(2)(i) states that a change in the obligor on a debt instrument is a modification, even if it occurs by operation of the terms of the instrument.

Treas. Reg. § 1.1001-3(e)(1) provides that a modification is significant if, under all of the facts and circumstances, it alters legal rights or obligations to a sufficient degree such that the alterations are economically significant.

Treas. Reg. § 1.1001-3(e)(2)(ii) provides that a change in the yield of a debt instrument that exceeds 25 basis points or five percent of the annual yield on the unmodified instrument is a significant modification. A change of ■■■ basis points is not a significant modification. Treas. Reg. § 1.1001-3(f)(2).

The yield computations under § 1.1001-3(e)(2)(ii) are based on the adjusted issue price of the unmodified instrument on the modification date, plus any accrued but unpaid interest, less any accrued bond issuance premium not yet taken into account. Treas. Reg. § 1.1001-3(e)(2)(iii).

Treas. Reg. § 1.1001-3(e)(4)(i)(A) provides that the

substitution of a new obligor on a recourse debt instrument is a significant modification.

Treas. Reg. § 1.1001-3(e)(4)(i)(C) provides that the substitution of a new obligor is not a significant modification if the new obligor acquires substantially all of the assets of the original obligor, there is no change in payment expectations, and the terms of the debt instrument are not significantly altered.

Treas. Reg. § 1.1001-3(e)(4)(iv)(A) provides that a modification that releases, substitutes, adds, or otherwise alters the collateral or a guarantee is a significant modification if the modification changes the holder's payment expectations.

Treas. Reg. § 1.1001-3(g)(4) prohibits the cumulation of significance factors of different types. If a given modification is not significant standing alone, it cannot be made significant by aggregation with other modifications.

In Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), the Court held that a mortgage company realized a deductible loss on the exchange of one portfolio of mortgages for another. The taxpayer's "legal entitlements" changed because the a new obligor was substituted for the former obligor and the obligation was secured by different properties.

I.R.C. § 1.1001-3(c)(6) provides that a modification occurs on the date of the agreement under which the terms of the debt are changed. When the agreement is conditioned on reasonable closing conditions, such as senior creditor or shareholder approval, the modification occurs on the closing date of the agreement.

I.R.C. § 1273 provides rules for computing the amount of the original issue discount associated with a debt obligation.

I.R.C. § 1273(b)(3)(A) provides that the issue price of a publicly traded debt instrument is its fair market value.

Treas. Reg. § 1.1273-2(b)(2) provides that the fair market value of a publicly traded debt instrument is established on the Issue Date, defined as the first date on which a substantial amount of the instruments is issued.

I.R.C. § 1273(b)(3)(B) provides that the fair market value of a debt security issued in exchange for publicly traded

securities is its fair market value.

Treas. Reg. § 1.1273-2(c)(2) provides that the fair market value of a publicly traded debt instrument is established on the Issue Date, defined as the first date on which a substantial amount of the instruments is issued for traded property.

I.R.C. § 1275(a)(2) provides that the Issue Date of a publicly offered DI is the date on which the issue is first issued to the public.

Treas. Reg. § 1.1502-13(g) governs the treatment of the intercompany obligations of members of a consolidated group.

Treas. Reg. § 1.1502-13(g)(3)(A) provides that if a member realizes an item of gain or loss from the assignment or extinguishment of all or part of an intercompany obligation, the intercompany obligation is treated as satisfied for all federal income tax purposes.

Treas. Reg. § 1.1502-13(g)(4)(A) states that paragraph (g)(4) applies if an obligation that is not an intercompany obligation becomes an intercompany obligation.

Treas. Reg. § 1.1502-13(g)(4)(B) sets forth exceptions to the application of paragraph (g)(4), none of which apply to the instant case.

Treas. Reg. § 1.1502-13(g)(4)(ii)(B) states that if paragraph (g)(4) applies to an intercompany debt, the debt is treated for all Federal income tax purposes as satisfied immediately after becoming an intercompany debt, with new debt issued to the holder in an amount determined under the principles of § 1.108-2(f).

Treas. Reg. § 1.1502-13(g)(4)(ii)(C) states that the attributes of all items taken into account from the satisfaction are determined on a separate entity basis, rather than by treating the holder and issuer as divisions of a single corporation.

#### DISCUSSION

##### 1. The sale or exchange approach

The Agent challenges [REDACTED]'s deduction on the ground that a significant modification of the old debt did not occur. The arguments against recognition can be summarized as follows.

- Economic substance should override the literal language of the Regulations and Cottage Savings. The debt holders were at least as well off after the exchange as before, as shown by their overwhelming acceptance of the Exchange Offer and the fact that the new DIs were given the same credit rating as the old by Moody's and Standard and Poor's.

- The change in yield did not meet the 25 basis point threshold of Reg. § 1.1001-3(e)(2)(ii).

- The indenture covenants remained largely unchanged.

- [REDACTED]'s management, staffing, and quarters were the same as [REDACTED]'s.

- While it is the general rule that a change in obligors is an automatic significant modification, Treas. Reg. § 1.1001-3(e)(4)(i)(C) provides for an exception when substantially all of the former obligor's assets are acquired by a new obligor and payment expectations and the terms of the debt are unchanged.

- The "substantially all" requirement in § 1.1001-3(e)(4)(i)(C) should not be applied too strictly. It fails to recognize that a corporation can adopt whatever legal structure will achieve the tax result it wants.

- Letter Ruling 9711024 (Dec. 12, 1996) confirms that the Exchange was not a taxable event. The taxpayer owned stock in three corporations. It transferred two of the corporations to a new subsidiary, along with debt obligations related to the transferred businesses. The debt holders were asked to release the transferor from liability on the notes, leaving the new subsidiary as the sole obligor. The ruling held that a substitution of obligors had occurred, but not a taxable event. The new subsidiary had acquired substantially all of the old obligor's assets, so the change in obligors did not trigger a taxable sale or exchange. Reg. § 1.1001-3(e)(4)(i)(C).

The arguments favoring the conclusion that the Exchange was a taxable event are as follows.

- [REDACTED] did not acquire substantially all of [REDACTED]'s assets. [REDACTED] represented [REDACTED] of [REDACTED]'s assets, revenues, and net income. [REDACTED] is not "substantially all" under any test.

- If the debt holders' payment expectations did not change, that result might be attributed as readily to the debt holders'

evaluation of [REDACTED]'s creditworthiness as to a perception that nothing had changed.

- In fact, the debt holders' payment expectations apparently did change. The interest rate on the new debt was [REDACTED] basis points higher than that on the old. If the Exchange was merely a substitution in form but not substance, the interest rate sweetener would not have been necessary.

We believe the Exchange was a taxable event under Cottage Savings and Treas. Reg. § 1001.3. Our reasoning is as follows:

- A substitution of obligors occurred, and the security for the obligations was substantially changed. These facts bring the case squarely within Cottage Savings.

- Letter Ruling 9711024 does not say what percentage of the consolidated entity was represented by z, the corporation removed as an obligor. The omission of this crucial fact vitiates the ruling's usefulness for either side.

- The Exchange was indisputably driven by business, not tax. It is impossible to identify any step in the transaction as strictly tax-motivated. No overreaching, loophole-exploitation, or tax abuses are apparent. In Cottage Savings, the exchange of mortgage portfolios was strictly tax-motivated, yet the taxpayer prevailed. The instant case lacks the foundation in equity that a substance over form approach requires.

## 2. Consolidated return regulations approach

The taxpayer argues that the consolidated return regulations authorize the deduction of the exchange premium. The arguments for this position are as follows:

- Treas. Reg. § 1.1502-13(g)(4)(ii)(B) directly addresses the situation in which debt issued by a member of a consolidated group is acquired by another member from a nonmember. Acquired debt is expressly recognized as intercompany debt by the regulations.

- Treas. Reg. § 1.1502-13(g)(4)(ii)(B) provides that the effect of the acquisition of member debt from a nonmember is an immediate deemed satisfaction by the obligor. The regulations thus lead to precisely the same result as the taxpayer's purchase-dividend transaction.

- Treas. Reg. § 1.1502-13(g)(4)(i) provides that the gain or loss on the deemed satisfaction of intercompany debt acquired from a nonmember belongs to the issuing member. Here the regulations again lead to the same result as the taxpayer's purchase-dividend transaction. The loss is allocated to [REDACTED].

The Agent disagrees with the taxpayer's analysis. He makes the following points:

- [REDACTED]'s DIs were not "issued", within the meaning of Treas. Reg. § 1.1273-2(b)(2), or, alternatively, § 1.1273-2(c), until [REDACTED] or later, at which time [REDACTED] was no longer a member of the [REDACTED] consolidated group. Therefore, the consolidated return regulations do not apply to the Exchange.

- The consolidated return regulations do not cover transactions like the Exchange. [REDACTED]'s DIs were not intercompany obligations and did not become so when acquired by [REDACTED]. The legal documents governing the restructuring provided that the [REDACTED] DIs would become void when they were acquired by [REDACTED]. Therefore, Treas. Reg. § 1.1502-13(g)(4)(A), which applies when the debt of one member of a consolidated group is acquired by another member, is not relevant. [REDACTED]'s DIs were unenforceable once [REDACTED] acquired them. They were not even debt, much less intercompany debt.

- The circular non-cash exchange whereby [REDACTED] "purchased" its debt from [REDACTED] for an amount that [REDACTED] immediately paid back to [REDACTED] as a dividend was a sham to make it appear that an intercompany transaction had occurred and to enable [REDACTED] to take an artificial deduction on the Exchange.

Our conclusion is that the taxpayer's position is correct. We base our conclusion on the following facts and legal principles:

- We do not think the definition of "Issue Date" for tax purposes is absolutely clear. It seems to us that any of several definitions might apply, including the one the Agent relies on, Treas. Reg. § 1.1273-2(b)(2). We are reluctant to approve the disallowance of an otherwise unobjectionable deduction based on the possibility that a ministerial act might have been done two days late, when a "bright-line" date has not been clearly established.

- Treas. Reg. § 1.1273-2(b)(2) is one of a series of rules fixing specific measurement dates according to the nature of the instruments involved in the exchange. The Issue Dates set forth in these valuation regulations are valuation dates, not necessarily recognition dates.

I.R.C. §§ 1273(b)(1) through (4) and Treas. Reg. §§ 1.273-2(a) through (d) set forth valuation methods for various kinds of debt instruments. A corresponding Issue Date is specified for each valuation method. I.R.C. § 1275(a)(2) seems to refine the meaning of "Issue Date," but no regulations have been promulgated thereunder to indicate the meaning of the apparent refinement.

I.R.C. § 1273(b)(3)(A) and (B) are the only subsections of § 1273(b) that might be relevant to the instant case. On the face of the statute, either could apply. Whether it matters which is applied is debatable. I.R.C. § 1273(b)(3) applies when debt is issued for property, i.e., something other than money. I.R.C. § 1273(b)(5). Subsection (A) under § 1273(b)(3) applies when the acquiring debt is traded on an established securities market. Subsection (B) applies when the acquired property is traded on an established securities exchange. In either case the issue price of the debt is the fair market value of the property for which the debt was issued.

Treas. Reg. §§ 1.1273-2(b) and (c) mirror I.R.C. § 1273(b)(3)(A) and (B), except that (c) gives priority to (b) by stating that (c) applies only if (b) does not. Subsection (b) of § 1273-2(b) applies when the acquiring debt is traded on an established securities market. Subsection (c) applies when the acquired property is traded on an established securities market. However, since (c) provides that (c) applies only if (b) does not, (c) can apply only when the acquiring debt is not traded. If the acquiring debt is publicly traded on an established market, (b) applies. If it is not traded, (c) applies. As far as the standard of valuation is concerned, it does not matter whether (b) or (c) applies. The standard is fair market value in either case. However, the definitions of Issue Date differ slightly between (b) and (c). When (b) applies, the Issue Date



is the date on which a substantial amount of the acquiring debt is issued. When (c) applies, the Issue Date is the date on which a substantial amount of the acquiring debt is issued "for traded property." We think the phrase "for traded property" is merely descriptive. We do not think it necessarily implies that a different valuation test is to be applied. As discussed below, the Agent alternatively asserts that either (b) or (c) may apply.

I.R.C. § 1275(a)(2)(A) defines the phrase "date of original issue" as "the date on which the issue was first issued to the public." Since the phrase "date of original issue" is not found in I.R.C. § 1273(b)(3) or Treas. Reg. § 1.1273-2(b) or (c), § 1275(a)(2)(A) may not have been intended to apply to those sections. We do not think "issued to the public" was intended to mean anything substantially more than "issued."

I.R.C. § 1275(a)(2)(A) applies only if the acquired property is publicly traded. Debt instruments issued to acquire property would not be "issued to the public" if the acquired property were not publicly traded. Publicly traded acquired property can fall under either Reg. § 1.1273-2(b) or § 1.1273-2(c). The distinction between (b) and (c) is based on the character of the acquiring debt, not that of the acquired property.

The Agent argues, as we understand it, that either Reg. § 1.1273-2(b) or § 1.1273-2(c) may apply to the valuation of [REDACTED]'s DIs. If the former applies, the Agent argues, the Issue Date was [REDACTED] because that was the date the Exchange Agent was required to issue the securities to the debt holders.

If Reg. § 1.1273-2(c) applies, the Agent argues, the fair market value of [REDACTED]'s debt should be determined by reference to the market value of [REDACTED]'s debt immediately prior to the Exchange, not by an estimate of fair market value on the date of the Exchange. The Agent bases his argument on the phrase "for traded property" in Reg. § 1.1273-2(c). The Agent claims that the market value of [REDACTED]'s debt was substantially lower than [REDACTED]'s estimate. The Agent argues that his valuation position locks him into the position that the Issue Date was the date on which the new debt was "issued to the public," as stated in I.R.C. § 1275(a)(2)(A). While we agree that both of these provisions seem to concentrate on the involvement of third party debt holders in fixing the Issue Date, we disagree with the Agent's conclusion.

First, we fail to see how Reg. § 1.1273-2(c) could apply at all. Subsection (c) applies only if subsection (b) does not.

Therefore, (c) is applicable only if the acquiring debt is not traded. This is the interpretation given the regulations in Tax Management Portfolio No. 535, "Time Value of Money: OID and Imputed Interest." The regulation is explicit on the point, and we do not see how any other reading is possible. There is no disputing that both the [REDACTED] DIs were traded on an established market.

Second, we have been unable to think of a policy justification for the Agent's interpretation of the law. We think the rule advocated by the Agent would interfere with the common business practice of making reorganizations effective on a single date, as in the restructuring of [REDACTED]. A common byproduct of a restructuring is the realignment of consolidated return groups. Issuing securities to a large group of security holders inevitably requires time. It seems to us that the Agent's position would make it difficult or impossible for the legal, economic, and tax effects of a restructuring to coincide. Such a rule would create difficulties for taxpayers that could not be defended on policy grounds. In fact, we are inclined to think the Agent's position might have undesirable policy consequences in some cases. It gives taxpayers control over the timing of recognition. Recognition of the tax consequences of a transaction could be postponed by establishing the most advantageous date for issuance of securities.

Support for the proposition that the valuation rules are not to be read overly strictly can be gleaned from Field Service Advice 1999-665, 1999 TNT 110-52. This FSA discusses whether § 1273(b)(3) should be read, as it literally says, to require actual trading of the securities in question in an established securities market. It concluded that the existence of a market from which representative prices could be determined was sufficient. The FSA quoted Rev. Rul. 75-117, 1975-1 C.B. 273: "[t]he significance of stock 'being traded on an established securities market' for purposes of determining its fair market value relates to uniform valuation, not the ease with which specific shares of stock can be disposed of on the market." In other words, valuation rules should not be applied to determine substantive tax consequences.

- Other provisions arguably conflict with, or at least authorize some latitude, in defining the Issue Date. Treas. Reg. § 1.1001-3(c)(6) states that an agreement to change a term of a debt instrument is a modification at the time the issuer and holder enter into the agreement, even if the change in the term is not immediately effective. Section 1.1001-3(c)(6)(i) states that if the parties condition a change in a term of a debt

agreement on reasonable closing conditions, the modification occurs on the closing date of the agreement.

The Agent argues that Treas. Reg. § 1.1001-3(c)(6) and the examples given there are addressed to modifications of the terms of debt instruments, not to the exchange of one obligation for another. However, § 1.1001-3(a)(1) says "[T]his section applies to an exchange of a new instrument for an existing debt instrument, or to an amendment of an existing debt instrument," and § 1.1001-3(b) provides that a significant modification results in an exchange of the original debt instrument.

- In the instant case, all material events, especially the election by the debt holders to exchange, were completed on or before [REDACTED]. All the fundamental legal relations were fixed as of [REDACTED]. The steps that followed were ministerial. While the Exchange Agent was not required to deliver the new DIs to the debt holders until [REDACTED] delivery was a bookkeeping matter of electronically executing book-entries, not a condition precedent or a condition subsequent to the Exchange.

- Even if there were an ironclad rule defining the Issue Date as the date on which securities are physically transferred to the holders, a tenable argument can be made that the [REDACTED] DIs were in fact transferred to the holders on [REDACTED]. This was the date on which the new notes were delivered to [REDACTED] for transfer to the debt holders. Since [REDACTED] was an agent of the debt holders (albeit an agent of [REDACTED] and [REDACTED] as well,) the transfer to [REDACTED] can reasonably be viewed as a transfer to the debt holders.

Following are our comments on the consolidated return approach.

- The Agent's argument that [REDACTED]'s debt had no value once it was acquired by [REDACTED] does not seem correct. The argument confuses the ultimate result of the plan with an intermediate step. The ultimate result of the plan was undeniably the substitution of the new obligations and cancellation of the old. The Agent quotes the prospectus as saying the old obligations would be valueless. We read the prospectus language as describing the intended ultimate result of the Exchange and restructuring. That the old obligations would eventually be canceled does not imply that they were worthless at any point prior to the completion of all planned procedural steps and the fulfillment of all conditions.

- The circular transaction in which [REDACTED] "sold" [REDACTED]'s DIs to [REDACTED], then declared a dividend to [REDACTED] in the amount of the "sale price" was not abusive. The restructuring plan called for the substitution of [REDACTED] debt for [REDACTED] debt. The substitution was not complete until [REDACTED] had been relieved of its obligations. The purchase-dividend transaction was the procedure the parties followed to formally relieve [REDACTED] of liability on the old DIs. The "circular transaction" was not necessary for tax purposes if Treas. Reg. § 1.1502-13(g)(4)(ii)(B) applied. It was a set of formal steps taken for corporate law purposes.

- If the [REDACTED] DIs remained enforceable in [REDACTED]'s hands, it follows that Treas. Reg. § 1.1502-13(g)(4)(ii)(B) applies. The regulation gives tax effect to the substance of the transaction. Under § 1.1502-13(g)(4)(ii)(B), [REDACTED]'s DIs became intercompany obligations when [REDACTED] acquired them, and they were deemed immediately satisfied. What the regulation "deemed," the circular transaction formally implemented.

### 3. Agent's alternative approach.

We next address the agent's alternative position, as expressed in his memorandum of [REDACTED]. As we understand it, the agent's argument is that the Code and regulations imply a preference for valuation by reference to real market prices rather than estimates like [REDACTED]'s. The agent reads Treas. Reg. § 1.1273-2(b)(1) to apply when publicly traded DIs are issued for nonpublicly traded DIs. Since [REDACTED]'s DIs were traded, § 1.1273-2(b)(1) does not apply. The applicable provision is § 1.1273-2(c)(1), which applies when debt is issued for publicly-traded property. The agent reads "fair market value" in the regulations and legislative history to mean the value of either the acquired or the acquiring obligations, whichever was actually traded in a regular securities market.

While the agent's argument that the most objective valuation information available should be used may be sound as a policy matter, we do not find support for it in the Code and regulations. As noted above, § 1.1273-2(b)(1) and § 1.1273-2(c)(1) say the value of the new obligations is their fair market value as of the applicable Issue Date. Both define "Issue Date" as the date a substantial amount of the new obligations is issued. Section 1.1273-2(c)(2) adds "for traded property," but we do not think it follows from these three words that the value of the new debt must be the traded value of the old debt.

Furthermore, the agent's interpretation makes a conflict between the pricing rules and the definition of Issue Date possible. If active market trading of the old securities ended before the date on which the new securities were issued, the Issue Date would necessarily occur prior to the issue of the new obligations. The Issue Date and the valuation date must coincide.

Finally, we do not agree that § 1.1273-2(b)(1) says or implies that the acquired property not be publicly traded. We read § 1.1273-2(b)(1) to apply whenever the acquiring DIS are publicly traded; the nature of the acquired property is not addressed. Our reading of § 1.1273-2(b)(1) makes it impossible to avoid the priority rule stated in § 1.1273-2(c): if § 1.1273-2(b)(1) applies, § 1.1273-2(c) does not.

#### 4. Agent's valuation methodology.

The agent's alternative position raises a non-legal question: why should it matter whether the [REDACTED] DIS are valued by reference to the traded market values of the [REDACTED] DIS or by [REDACTED]'s estimate? If the markets are efficient, the value of the old securities should not have differed materially from the value of the new ones. It is possible that [REDACTED] intentionally overestimated the value of the old securities to maximize the tax benefit of the deduction. Another possibility is that the agent's valuation of the [REDACTED] DIS is incorrect.

The agent's [REDACTED] memorandum raises concern that his valuation of the [REDACTED] DIS (on which he bases his valuation of the [REDACTED] DIS) may be erroneous. On page five, he makes the following statements:

36. A debt instrument's market value can be determined from its current yield. A current yield represents the percentage of a debt instrument's annual coupon payment over the debt instrument's market value.

37. Therefore, the formula to arrive at a debt instrument's current yield is: Current Yield = Annual Coupon/Market Value

38. Using algebra the market value, or issue price, can be determined by the following formula:  $\text{Market Value} = \frac{\text{Annual Coupon}}{\text{Current Yield}}$ .

Current yield is only a rough index of the coupon rate of return on a DI based on its current market price. It tells you what the current market price is, but does not tell you how the current price was set by the market. The market value of a DI is a function of its internal rate of return, or yield to maturity.

The yield on a DI is made up of three parts: coupon interest; interest on interest; and economic capital gain or loss. The first two elements will always be present. The third will be present unless the holder bought the instrument at par. The holder will receive only \$1,000 at maturity. If he bought the bond at a discount, he will have an economic capital gain. If he paid a premium, he will have a capital loss. The original issue discount rules spread the gain or loss over the term of the instrument, but do not change the fact or amount of the gain or loss. The issuer has an offsetting capital gain or loss if the DI was not issued at par.

The defect of the current yield method is that it takes into account only one of the three components of yield, coupon interest. The yield to maturity method takes all three into account, though it suffers from the assumption that all cash flows, including interest on interest, can be made at the computed original internal rate of return. More sophisticated valuation methods are used to avoid this problem, but the yield to maturity method remains the standard by which the market prices of bonds are set.

On the above principles, see, e.g., Fabozzi and Pollack, The Handbook of Fixed Income Securities, 2d Ed., especially Ch. 2, Fabozzi, "Bond Yield Measures and Price Volatility Properties," and Ch. 27, Leibowitz, "Total Aftertax Bond Performance and Yield Measures for Taxable Bonds Held in Taxable Portfolios."

It is not clear how the agent determined the market value of the [REDACTED] DIs. The following statements are made in his memorandum:

35. The Standard & Poor's Bond Guide lists the [REDACTED] debt's current yield and month end trading prices for each month in [REDACTED] and for [REDACTED].

38. (Second paragraph with this number). The following table lists the current yield and fair market values of the [REDACTED] debt instruments for a four month period beginning in [REDACTED] and ending [REDACTED].  
Standard & Poors Values: ...

39. [REDACTED]  
[REDACTED] is allowed a repurchase premium deduction in the amount of \$[REDACTED] using the Standard & Poor's [REDACTED] Values of the [REDACTED] Debt as the Issue Price of the [REDACTED] debt...

We do not understand whether the agent made his own computations of value or simply used reported market values as reported by Standard & Poor's. If the former, the calculations are not set forth and are not obvious from the memorandum. If the latter, the discussion of current yield is superfluous. Furthermore, certain statements in the memorandum are confusing. The second paragraph numbered 38, contrary to its expressed claim, lists coupon rates of interest, not current yields. Why is there a column labelled "[REDACTED]" for "Standard & Poor's Values" for the [REDACTED] debt if it was retired in [REDACTED]? Why is the value of such debt in [REDACTED] shown to be approximately the same as the pre-exchange value, when almost all of it was exchanged? Elsewhere the agent has represented that the amount of [REDACTED] debt not exchanged was so small that trading in it was halted by the New York Stock Exchange.

On [REDACTED] [REDACTED] issued a letter to the taxpayer defending its estimate of the fair market value of the [REDACTED] debt. As a test of the accuracy of its original method, [REDACTED] used Bloomberg historical data to determine the yield spreads between U.S. Treasury bonds and corporate BBB1 bonds with maturities similar to [REDACTED]'s. When the original study was done, historical data was not available, so [REDACTED] made its own estimate of the yield spreads.

[REDACTED]'s test based on actual historical data produced a result within one-half of one percent of the original valuation. The methods employed in both cases appear reasonable to us, and produce reasonable results. On the other hand, the agent's conclusions raise several questions.

We calculated the yield to maturity on the value of each issue, as determined by [REDACTED] and as determined by the agent. [REDACTED]'s results reflected the expected gradually rising yield curve, with only one value being outside the trend. The agent's values were random, exhibiting no trend at all. This violates the normal expectation that promised yields increase with maturity. See Exhibit A attached.

Another problem with the agent's valuations is the size and variability of the calculated yields to maturity. The agent's yields are, with one exception, higher than [REDACTED]'s, and their standard deviation is higher. This additional variability must be due to perceived incremental company-specific risk. We do not understand why the risk premium should vary so greatly, nor what would account for the irregular pattern of variation. We also do not understand why the risk premium on [REDACTED]'s bonds should be higher than the risk premium on similarly rated corporate debt instruments.

If the agent's valuations are too low, his alternative legal position under Treas. Reg. § 1.1273-2(c) could be well be moot.



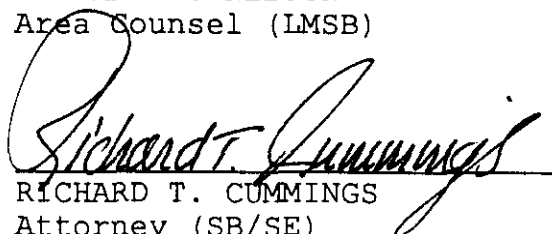
CONCLUSION

For the reasons set forth above, we conclude that [REDACTED]  
[REDACTED]'s deduction of the repurchase premium was correct,  
whether analyzed under the sale or exchange approach or under the  
consolidated return regulations. We do not accept the agent's  
alternative position, and even if we did, we would question the  
accuracy of his valuation computations.'

Sincerely yours,

BERNARD B. NELSON  
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By:

  
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